FREE TRADE AND NATION STATES

Imperfections in the global economy

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ABSTRACT

This paper discusses several topics relating free trade to the concept of the nation state. Classical political economy, and later economics, developed without acknowledging any theoretical role for the nation state, which is basically considered as a distortion. Despite expressions of dissent from a few major economists, like Schumpeter, and the special case of Keynesianism, the issue has never been completely resolved. However, in many circumstances, and contrary to the standard approach, the nation state plays a key active role in the evolution of international flows, and should be theoretically incorporated. The present paper attempts to reintroduce this concept into the analysis, taking into account not only its more obvious features, i.e., the existing countries and governments, but also some other underlying factors of the nation state such as language, history and currencies, which are often neglected, even in the literature on complements and "exceptions" to free trade. In so doing, various imperfections become evident and consequently, the outcomes of free trade may be different to what is assumed in the standard analysis, while a more realistic picture of the world economy emerges. Although some research work has been carried out on this subject, particularly since the 1980s, much remains to be done in order to include these elements fully into the theoretical analyses.

1. Introduction

Free trade remains a highly challenging issue, which is simultaneously attractive and unsatisfactory as a tool to help us understand the real world. Theoretically, from the unilateralist perspective, i.e., regardless of the behavior of its partners, a country that follows free trade policies should spontaneously benefit through better and cheaper provision of goods and services. This result would occur as a consequence of the specialization of national economies, and concomitantly, enhanced efficiency and increased welfare. However, if one considers more carefully the notion that free trade means no obstacles to international flows and that all countries are placed on a level playing field leading to shared gains, its effectiveness is much less evident than it first appears. It is sufficient to observe that countries of comparable size, subject to the same external rules and with similar degrees of openness may have quite different performances (for example, within the European Union). Thus, even if we admit that other factors also account for these differences, we can hardly refute the assumption that free trade *per se* may not automatically entail the optimal outcome for a particular country that simply takes the international specialization avenue. The reason for this lies in the fact that under the conditions in which barriers usually identified in most textbooks of international economics do not exist or are negligible, many imperfections still portray external flows (associated with the nature of exchanged goods, the length of time of the process and other driving factors), and free trade is a mirage. Moreover, some of the barriers are naturally determined by national, political and cultural aspects, which are deeply imbedded in the course of international trade as its domestic bases. Therefore, all these imperfections need to be taken into account if we want to be fully conversant with the way the world economy actually runs.

After these brief introductory remarks we shall focus on the imperfections referred to above. Free trade will be examined considering the role of nation states at the core of the world economy, as well as how trade is influenced by language and history, in addition to the persistence of a significant national power over currencies in many cases and situations. In the final section, we present our concluding remarks.

2. The nation state in the economics of free trade

The nation state which is by nature a structural basis for trade, foreign investment and other flows plays a key role in the internationalization process and its dynamics. Yet, for reasons explained below, linked to the very roots of political economy, this dimension has for a long time been neglected. In an attempt to fill this gap, Hirschman in his seminal work *National Power and the Structure of Foreign Trade* (1945) introduced national sovereignty into the "toolkit" of economics analyzing the classical notion of the gains of trade, showing how it implies imperfections and indeterminacy, and ultimately produces asymmetrical pay-offs, far from those assumed in mainstream textbooks. However, his contribution has largely remained underestimated (Silva, 1999b). Such a missing link in the theoretical analysis has affected the understanding about the way how free trade operates, and has been firmly opposed by some major authors (Williams, 1929, Schumpeter, 1954). Nevertheless, the main developments in economics have in general coexisted with this flaw without seriously trying to incorporate the nation state into the theory. We argue that within the context of globalization, where free trade issues, particularly those concerning the nation state, become theoretical elements of the first order, we need a sounder and deeper introduction of the concept as part of a more realistic approach to international economic relations. Indeed, the theory of free trade was established a long time ago and its oversimplification, as well as its superficial and contradictory perception of the subject, is no longer acceptable. Our basic argument in this paper will be that free trade in the presence of nation states considerably shifts the theoretical focus with regard to the way how international competition effectively functions.

Until a few decades ago, the most direct solution for supporting the free trade idea was to exclude the nation state from the theoretical corpus of international economics, or to describe its interferences in external transactions as moves away from the best outcome. Yet, in the post-war period, as shown by the gradual decline of tariffs and non-tariff barriers as well as the increasing international mobility of factors, particularly that of capital, the same problem holds: a level playing field between countries and symmetrical gains remain elusive in a free trade context. Taking into consideration these premises, we need to analyze the role played by the nation state in the present international environment from several angles. Clearly, there are other related subjects not developed here that also deserve clarification from our point of view. For example, the question whether some special cases of protectionism – measures inducing the specialization in goods produced in industries with increasing returns to scale, a correct management of the infant-industry argument towards maturity and competitiveness, the subsidized "import" (and similar policies) of highly-skilled professionals in view of increasing national productivity, and the use of the optimal tariff or its substitutes for big countries in order to improve their terms of trade[1] -, may or may not lead to benefits uniquely for the imposing partner or, at least to uneven gains. These "exceptions" that challenge the dominant view on free trade and specialization, postulated in most textbooks, are taken into consideration in many of them, although only partially and not in all their consequences. Hence, our approach leads us to focus on the debate over some of the less studied dimensions of the nation state's role within a world economy without significant traditional barriers (tariffs, non-tariffs, controls of capital, and the like).

In spite of the fact that international economics has developed under very restrictive assumptions, free trade must be associated with many other relevant aspects that underlie the formal definitions and principles of the pure discipline. This is a pre-requisite for an understanding of all that is at stake in the movement of international flows. One of the most outstanding examples of oversimplification in the field of international trade is the Ricardian theory of comparative costs based on the *2 goods–2 countries* approach, measured by the relative

[1] For a view of the various arguments in this respect, according to the guidelines of the mainstream approach (i.e.,

number of hours per man required to produce the goods in each country. Indeed, in order to explain the comparative advantage of a country in foreign trade, we need to take much more into account than the simple cost of the traded good (in autarky or openness) and to know how such a good is produced and exchanged at a particular moment. Among other contributions, to introduce the nation state constitutes a step forward in the understanding of all the process. For example, the catching up achieved in the post-war era by an increasing number of trading countries, particularly in Asia, demonstrates that adequate policies and strategies implemented on a national scale, and properly led by governments can be decisive in this outcome. As Krugman put it: "Nations matter because they have governments whose policies affect the movements of goods and factors".[2] While this author thinks mainly in terms of restrictive actions, governments may operate in both ways (protectionism and free trade), and make its appropriate mix when necessary.

Although some features deriving from the concept of the nation state were accepted from the outset by the classics for analytical purposes (for example, the assumption of national, though not international, mobility of factors[3]), others were not considered, such as the existence of common national interests and wants easily transferred to international commercial and financial transactions. The result was that since Adam Smith, the economics of free trade has been constructed on the basis of a narrow perspective, which has discarded a global and more complete approach. Schumpeter (1954) was quite clear on this issue:

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basically disapproving or minimizing their impact), see Irwin, 1996, 2002.

[2] P. R. Krugman, *Geography and Trade*, Leuven University Press and the MIT Press, Leuven and London 1991, pp. 71-2.

[3] In this example, according to the classical way of thinking, the movement of factors particularly that of capital, contradictorily denies the virtues of free circulation attributed to trade in goods. See the well-known statements on this subject in Chapter VII of Ricardo's *Principles* (1817).

> "If Smith and his followers had refined and developed the 'mercantilist' propositions instead of throwing them away, a much truer and much richer theory of international economic relations could have been developed by 1848 – one that could have not been compromised by one set of people and treated with contempt by another."[4]

One of the strongest criticisms that Schumpeter addressed to Smith was thus the fact that in his zeal in refuting mercantilist theories and eliminating the nation state from the picture, he opened the way to incomplete views of free trade's advantages, satisfying one group of people in terms that are unacceptable to another group, preventing the development of a richer, more comprehensive and refined theory of international economic relations. It is true that Smith acknowledged the role of the state in many areas, and even promoted it in specific issues of international trade (e.g., his support of the Navigation Act), but theoretically, given the "invisible hand", it remained dependent on other considerations, for example "defense instead of opulence", rather than having a theoretical value of its own. This is also clear as far as the specialization process is concerned, in which Smith launched his stepping stone of the division of labor in terms of an individual firm within national frontiers, rather than among countries. Nonetheless, the internationalization of production is presently common place for the rapidly increasing number of firms participating in world trade and investment. Later, neo-classical authors like Heckscher and Ohlin changed some of the classical model assumptions, for example, introducing a second factor of production, but did not question its basic message. Also, in the interwar period, Keynes recognized the role of the state and governmental actions, but this was mainly conceived in the context of closed economies, also with some exceptions, particularly in his proposals for the international monetary order of 1942 (creation of an international

[4] J. A. Schumpeter, *History of Economic Analysis*, Allen and Unwin, London 1954, p. 376.

currency called the bancor, countervailing functioning of the surplus and deficits of different countries participating in the world system of trade and payments, etc.).[5]

Despite the prevalence of the classical viewpoint, the nation state has remained a pivotal force, influencing international flows not necessarily opposed to free trade, in the sense of the existence of formal obstacles to circulation, but rather associated with it. Even in areas of deep economic integration such as the European Union, where some traditional attributes of the nation states seem to have been reduced or have faded (e.g., exchange rates and basic interest rates in "Euroland"), they nonetheless remain crucial for the understanding of international flows, not only because of the EU policymaking apparatus, but also through less visible channels that provide asymmetrical information to the economic agents of a particular location. By this, again, we do not mean traditional instruments like the raising of tariff and non-tariff barriers or controls of factors, but through less visible means that likely provide a much more powerful basis for networks that drive trade and other flows in one or another direction. Also, since the beginning of the 20th century, the number of independent states has approximately tripled and this trend must have some kind of economic rationality. This is a very important point at a time where there is a widespread conviction that nation states are fading, if not they are a mere remnant of previous eras.

To summarize, even if the long term interests of a nation state can best be served by free trade, in the sense that the absence of tariff and non-tariff barriers, controls of factors and so on, improve welfare and efficiency, this must not conceal a large number of specific characteristics arising from the fact that the role of the nation state can make all the difference in the global

5.For details see G. J. Ikenberry, *A world economy restored: expert consensus and the Anglo-American postwar settlement,* 'International Organization', Vol. 46, nº 1, 1992, pp. 289-321.

marketplace (whether advantageous or not it depends on the adequacy of the implemented policies and strategies).

3. The influence of language and history in the direction of international flows

With regard to the imperfections mentioned earlier, one perspective leads us to examine the external relations between countries, particularly those that have some forms of cultural proximity, which is relevant in the globalization era, characterized as it is by increasing economic interdependence and growing cross-border flows. This evolution can be described as follows: "Under conditions of full, free international competition, a country will best be able to maintain its position in areas with which it has a strong cultural affinity".[6] Since countries are often bound by a set of common features such as language and history, the influence of these factors on trade and other international movements can be felt in a number of ways.[7] If such links are taken into account, not all nation states are on a level playing field from the free trade point of view, including related direct consequences such as specialization.

The case of a common language binding different countries is highly illustrative of this phenomenon. The diversity of language is often presented as an obstacle to flows, particularly for multinational firms, but, at the same time, it is widely recognized that they also have a strategic potential for international actors.[8] Indeed, languages can be important trade creators:

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[6] P. van Bergeijk, *The significance of political and cultural factors for international economic relations*, in C. J. Jepma and A. Rhoen, Eds, "International Trade, A Business Perspective", Longman and Open University of the Netherlands, London 1996, p. 210.

[7] Cultural proximity (as well as differences), although a more complex issue, has been explored since the middle of the 1970s in the literature on the internationalization of firms, for example by the Uppsala model (Johanson and Vahlne, 1977); according to this approach, in the first stage of the process, firms internationalize where there is less cultural or psychic distance.

[8] Y. Luo, and O. Shenkar, *The multinational corporation as a multilingual community: Language and organization in a global context*, 'Journal of International Business Studies', Vol. 37, nº 3, 2006, p. 322.

> "Cultural factors influence trade relations by various routes. The most obvious example is language. First of all, there is a strictly economic aspect involved with language: having a common languages reduces the costs of information transfer, such as advertisements and user instructions …The mirror image of this is costs associated with language differences, for example the various languages spoken in Europe create a situation where the internal market can never be perfect: the smaller linguistic communities in particular will continue to experience major barriers that segment the internal market. The impact of a common language is broader, however. Consumer preferences are in fact shaped partly by the media and therefore a common language used in a wide area is a major asset in the creation of international trade."[9]

The effect of language may seem relatively unimportant in the context of many bilateral and multilateral trade relations; however, as argued by Mises in his work *Nation, State, and the Economy* (1919), we need to take into consideration that this is a primary factor to the identification of a nation state ("what is specifically 'national' lies in language"[10]). Obviously, "community of language binds and difference of language separates persons and peoples"[11], but there is no contradiction between this and the conclusion that a large use of a *lingua franca* is necessary; both phenomena are simultaneously relevant in the globalization context. Furthermore, if language actually plays a key role in the nation state,[12] what is still more important is to look at the economic consequences of this process.[13]

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[9] P. van Bergeijk, *op. cit.,* p. 210.
[10] L. von Mises, *Nation, State, and the Economy, Contributions to the Politics and History of our Time*, English translation, New York University Press, New York 1983, p. 11.
[11] Idem, p. 12.
[12] L. von Mises even separated the notion of the nation state into its two elements, meaning that we may have different states within the same nation state ("the criterion of the nation should in no way be sought in efforts to form a unified state"; idem, pp. 18-9).
[13] Also, it is important to acknowledge that there is in general an increasing interest on the role of language on economics from various perspectives; see for example the papers collected in Lamberton, 2002.

For trade purposes, *ceteris paribus*, countries with the same language have thus less communication costs between them, and consequently relative smaller barriers to the free movement of goods, services and factors (a common language appears as trade facilitator). It also leads to the creation of larger natural markets for some products (particularly those dependent on language, for example media products). Thus, this link may have profound consequences for the producers and consumers of concerned countries under free circulation, and in the conditions of tough competition prevailing within the context of globalization (in which firms seek to profit from the smallest advantages). Even firms of third origin, i.e. not belonging to the same linguistic group, can take advantage of this cross-border proximity. The empirical work on various cases has largely demonstrated the relevance of linguistic ties to trade (Breton, 1999).[14] The boom in foreign direct investment and the capital movement of the last two decades has allowed new tests, suggesting the same correlation between language and these flows (Silva, 1999a, 2005).

With reference to historical ties, Eichengreen and Irwin (1998) studied empirically different groups of countries bound by such ties, concluding that the past flows determine to some extent the present ones. Moreover, they consider that the influence of this factor has often been wrongly overshadowed by the preference for economic integration as the explaining variable:

> "We have argued that both theory and evidence suggest that history plays a role in shaping the direction of international trade … Because there are reasons to anticipate a positive correlation between the predominant direction of trade flows in the past and membership in preferential arrangements in the present, there may be a tendency to

[14] See, for example, the empirical surveys included in the work edited by Breton, who, in presenting their results, emphasized: "It is because of language that English or German-speaking countries trade more with each other than with other countries and not because – as is the case with German-speaking countries – they are neighbors. This is a very important result", in A. Breton, *Exploring the Economics of Language*, New Canadian Perspectives, Canadian Heritage, Ottawa 1999, p. 1).

> spuriously attribute to preferential arrangements the effects of historical factors and to exaggerate the influence of the former."[15]

In addition, these authors criticize the use of the standard gravity model as a basis for explaining bilateral trade, insofar as it gives preference to physical variables such as distance and economic size, while regarding history as inappropriate.[16]. A similar move towards the acknowledgement of the relevance of history is clear in the field of international business (Jones and Khanna, 2006).

It must also be pointed out that in present-day globalized economies and business, the ability to take advantage of this kind of linkage, on the one hand, language and history, on the other hand, trade, FDI and other international transactions, is a scarce resource. Indeed, as stressed by an author quoted by Rauch (2001) in a paper relating business social networks to international trade flows:

> "Today …new transportation and communication technologies allow even the smallest firms to build partnerships with foreign producers to tap overseas expertise, cost-saving, and markets … The scarce resource in this new environment is the ability to locate foreign partners quickly and to manage complex business relationships across cultural and linguistic boundaries …The Chinese and Indian entrepreneurs of Silicon Valley … are creating social structures that enable even the smallest producers to locate and maintain mutually beneficial collaborations across long distances".[17]

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[15] B. Eichengreen and D. A. Irwin, *The Role of History in Bilateral Trade Flows*, in J. A. Frankel, ed. "The Regionalization of the World Economy", NBER/University of Chicago Press, Chicago and London 1998, pp. 55-6.

[16] Idem, p. 56.

[17] J. E. Rauch, *Business and Social Networks in International Trade*, 'Journal of Economic Literature', Vol. XXXIX, December, p. 1177.

Therefore, the relevance of the nation state and its underlying features within the free trade paradigm is not only valid bilaterally, but also for a group (or groups) of countries and international actors, like firms and states, of the most diverse origins. Indeed, they can be connected through natural networks created on a world-wide scale that, by means of knowledge, introduce imperfections into the competitive process, intended to produce some kind of effective advantage for the players. From a global point of view, it is necessary to consider these peculiar features between countries or groups of countries as indispensable for a correct explanation of flows under free trade, the distribution of their gains and other related aspects.

4. Currency disequilibrium and the international trading system

One of the main channels through which the nation state plays a significant role in the world economy is the currency. Indeed, the power exerted over this instrument may distort free trade as a pure search for efficiency and also lead to unequal gains. Even if in some historical periods, the world economy has been served by an international currency acting as a level playing field for different countries, such as in the gold standard era, or with a particular national currency as in the Bretton Woods system (US dollar), states can actually manipulate their own currency. Moreover, they often substantially shift the course of trade through exchange rates insofar as they alter the level of relative prices among trade partners. Despite the fact that the European Union has recently created a common currency and that other countries have indexed their money to an anchor in order to reduce exchange uncertainties, the general currency disequilibrium that has largely prevailed in this field since the beginning of the 1970s may deeply modify the global competitive position of a country. In particular, states possessing reserve currencies, even though few, are attracted to use them unilaterally, more often for domestic purposes, because of their monopoly power resulting in palpable asymmetrical gains (McKinnon, 2001). In addition, such countries may benefit from lesser adjustment costs to trade-induced changes. In this light, it is clear why the United States strove throughout the 20th century for its currency's autonomy (Mundell, 2000). Furthermore, in the last three or four decades, the world's leading currencies have often shifted their relative value in a way that can hardly be based on economic fundamentals (for instance, suffice it to look at the frequency of sharp rises and falls of the same currency in the short term).[18]

After the Second World War, in order to reduce the disharmony between international monetary and trade orders, and its immense political consequences as experienced in the inter-war period, a degree of multilateral co-operation was sought (see, for example, Article XVI of the GATT, which established "exchange arrangements" with the International Monetary Fund). However, since the early 1970s, this approach has lost any practical relevance and many states have gained an important monopoly power in this field. Moreover, the creation of the WTO in 1995, with its set of new articles and regulations has not changed this framework and except for the highly-integrated regions, the cooperation between trade and exchange arrangements has been abandoned and free trade as such has been affected. As mentioned above, this is especially true for reserve currencies, international by name, but, in fact, belonging to particular countries that may use them either for domestic purposes or external influence. It is not necessary for all countries to have significant power over their currency; rather, it is enough that only some of them have it, particularly if they are powerful trading nations. This can alter the patterns deriving from free trade on a global scale, and lead to asymmetrical gains and advantages. Therefore, the national currency problem should be straightforwardly considered for the effects of its relationship with trade, at least by the international trading system in its search for the reduction and transparency of effective barriers. This major link however has so far been neglected, even by self-proclaimed advocates of free trade such as Jagdish Bhagwati. Indeed, in his works like *The*

[18] See for example, the highly unstable evolution of the exchange rate between the euro and the US dollar, since the

World Trading System at Risk (1991) and *Free Trade Today* (2002) that by their own nature should deal with this issue, but they barely mention the currency dimension of international trade. It is difficult however to find any free trade in situations in which the institutional manipulation of currencies constantly alters their relative value, thus having a strong impact on specialization and other aspects through changes (more often great rather than small) in international prices.

5. Concluding remarks

After a long period of stagnation and slow progress, the new globalization era has clearly speeded up the pace of theoretical change in international economics. Just to mention one example, the theory of imperfect competition was only more broadly recognized as relevant in this field (Dixit, 1983) some fifty years later than in industrial economics (in the 1930s). Indeed, the theories of trade emerged from the classical teachings and later schools of the mainstream approach within narrow limits that left in the shadow many core aspects of their developments, including those concerning the substance of international specialization, the relation with growth, and the distribution of gains in a long term perspective. Although truly consolidated advances have yet to take place, post-1980s globalization seems to provide more favorable ground for theoretical change and reform, while requiring careful scrutiny of the forces actually driving trade, foreign direct investment, and other international flows. For example, based on the history of economic thought, some authors have proposed as a key explanation for successful trade specialization, policies favoring industries with increasing returns to scale.[19] Others have pointed to the decisive role of technology in the process (Orati, 2003). Hence, this is a promising field for research, and it is likely that we are at a propitious moment for the strengthening of alternative analytical proposals.

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launch of the single European currency in 1999.

[19] This is the main theme of E. S. Reinert's book, *How Rich Countries Gor Rich … and Why Poor Countries Stay Poor*, Constable, London 2007.

In this context of change, we have examined a specific issue relating free trade with nation states and some of their major underlying factors which have impact on the development this link. On the one hand, the assumption of free trade as a general philosophy, including the suppression of any type of barriers (traditional tariffs, non-tariff barriers, controls over the movement of factors, including transnational mergers and acquisitions), may coexist with significant imperfections that, in fact, do not lead to a level playing field among partners participating in the international competition process. On the other hand, the concept of free trade as it is usually presented in textbooks and papers, i.e., without considering the role of the nation state, diverts from the study of true conditions under which this competition actually evolves. Some of the factors of this framework are enduring realities, such as nation states, languages and history, while others, for example national currencies, may be more historically determined in their relation to the international economic order. Whether the former or the latter, their influence on the direction of trade flows, according to our conclusion, cannot be overlooked.

Summing up, given the context of globalization as a favorable ground for free trade as well as a level playing field for all competing countries, the role of nation states must be fully integrated into the theoretical explanations if we consider that a flawed interpretation of the real world economy is unacceptable in theory and misleading in policy terms, even if this implies the recognition of long-lasting imperfections that cannot be blurred in the name of any convenient simplification.

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